DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 04-0398
Corporate Income Tax
Tax Period 2000-2002

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ISSUES

I. Adjusted Gross Income Tax – Forced Combination of Return

Authority: IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-3-2-2(p); IC § 6-3-2-2(m); IC § 6-8.1-5-1(b); Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).

The taxpayer protests the forced combination of its income tax return with its related corporations.

II. Adjusted Gross Income Tax - Apportionment

Authority: IC § 4-21.5-1-4(1); IC § 4-21.5-1-9; IC § 4-22-2-3(c); IC § 4-22-2-3(e); IC § 4-22-2-13(a); IC § 6- IC 3-2-2(a); IC § 6-3-2-2(l); IC § 6-8.1-3-3(a); IC § 6-8.1-5-1 (b); 45 IAC 3.1-1-38; 45 IAC 3.1-1-62; Metromedia, Inc. v. New Jersey Division of Taxation, 97 N.J. 313 (1984).

The taxpayer protests the audit's method of apportionment.

III. Tax Administration – Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

The Taxpayer protests the imposition of the negligence penalty.

Statement of Facts

The taxpayer is a wholly-owned subsidiary (Subsidiary A) that creates a product that is used by its parent company (Parent Corporation), a cable programming corporation, which then reimburses the subsidiary for the production of the product. A second subsidiary (Subsidiary B) is another wholly-owned subsidiary of Parent Corporation that does similar business to taxpayer; this second subsidiary also does business in Indiana. Both subsidiaries file corporate income tax returns in Indiana.

Parent Corporation receives money from licensing its broadcast rights to cable and satellite providers, who in turn charge a fee to their subscribers, which includes subscribers located in Indiana. The Indiana Department of Revenue conducted an audit of taxpayer's business records and tax returns from 2000 to 2002. In doing so, the audit determined taxpayer's adjusted gross income should be recomputed on a
unitary basis to reflect the income of Subsidiary A, Subsidiary B, and Parent Corporation.

As a result of the audit, the Department assessed additional adjusted gross income tax, interest, and penalty. The audit employed a method of apportionment based on satellite and cable subscribers within the state. Taxpayer, Subsidiary B and Parent Corporation protested this assessment. A hearing was held and this Letter of Findings results.

I. Adjusted Gross Income Tax – Forced Combination of Return

Discussion

During the audit review of taxpayer's state corporate income tax returns, the Department concluded that taxpayer should have been filing a combined return reflecting taxpayer's own income and that of its related corporations. The auditor concluded that "the operations of these entities are intertwined" and that "they are interdependent on one another to produce a marketable product." Because the parent corporation has sole control over what its subsidiary is paid, the auditor concluded that there would be sufficient distortion of income to necessitate the filing of a combined return in Indiana.

Taxpayer disagrees with the decision requiring the combined reporting. The taxpayer suggests that the distortion which supports the Department's decision mandating a combined reporting is without basis. Taxpayer contends that the reimbursement (or as taxpayer calls it, the fee) of the subsidiary taxpayer from the parent company was an arm's length negotiation and compares to fees they pay to third party producers. Taxpayer then contends that they are not responsible for the signals that the cable and satellite providers beam to Indiana (despite the fact that they still receive fees from providers, who in turn receive fees from their subscribers). Therefore, taxpayer argues, there is no provision of services from Parent Corporation to individuals in Indiana, and Parent Corporation is not subject to Indiana corporate income tax.

The taxpayer errs in its contention that IC § 6-3-2-2(p) grants the Department power to force a combined reporting. It is, in fact, IC § 6-3-2-2(m) which grants that power, and it states that:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In addition, IC § 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;
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> (1) separate accounting;
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> (2) the exclusion of any one (1) or more of the factors;
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> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is apparent from IC § 6-3-2-2(l) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment – including the combined reporting method – are only employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

Taxpayer relies on Letter of Finding No. 99-0399 for the proposition that "the mere receipt of revenue from an Indiana customer does not subject [Parent Corporation] to tax in Indiana." The taxpayer's reliance on this Letter is misplaced. Although it is conceded that taxpayer's contention might have merit were it only the Parent Corporation whose presence within the state was at issue, this is not the case here. It is the Department's determination that Parent Corporation is a *unitary entity* together with its subsidiaries, both of which are inarguably doing business within the state, as evidenced by their filing of tax returns.

Furthermore, taxpayer offers little support for its contention that the subsidiaries and its parent company are separate entities. Although the three entities – Subsidiary A, Subsidiary B, and Parent Corporation – maintain separate and distinct identities, the relationship between the three parties has all the hallmarks of a unitary relationship. The subsidiaries are owned, operated, managed and controlled by the same parent corporation; each is one operational facet of the parent corporation's multimedia operations. *See* Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).

Notices of proposed assessments are prima facie evidence that the Department's claim for unpaid taxes is valid**.** IC § 6-8.1-5-1(b). The taxpayer has the burden of proving that the Department incorrectly imposed the assessment. Id. Given the relationship between taxpayer, Subsidiary B, and Parent Corporation, the diversion of corporate income obtained from revenue via cable and satellite subscriptions, and their "interdependen[ce] on one another," the Department agrees with

the audit's conclusion that taxpayer and its parent corporation should have been filing a combined return in effort to "more fairly" reflect the group's Indiana corporate income.

Pursuant to IC § 6-8.1-5-1(b), taxpayer has failed to meet its burden of rebutting the presumption that the original audit decision was correct. Taxpayer has failed to demonstrate that combined filing requirement would distort the amount of income taxpayer received from conducting business within this state.

Finding

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax - Apportionment

Discussion

The audit determined that the taxpayer's business within the state, coupled with Parent Corporation and Subsidiary B's business within the state, evidenced a "unitary business." As a result, the audit found that taxpayer had a "unitary relationship" with its parent corporation and that taxpayer was required to report its Indiana income on a unitary basis. The audit proposed the use of an apportionment method based on the amount of cable and satellite subscribers in the state of Indiana (the subscriber ratio, or "audience factor" as the taxpayer terms it), stating that "[w]ithout programming subscribers in Indiana, the taxpayer would not generate revenue from advertising aimed at the Indiana audiences." The ratio was determined to be 2.07 percent, which was applied to the taxpayer's Gross Subscription Revenue, Advertising Revenue, and various other sources of revenue.

Taxpayer believes that the "cost of performance" method of apportionment is appropriate and that the "subscriber factor" is incorrect. Taxpayer offers two arguments to support this view. The first argument is that the Department has de facto adopted a rule by its use of the "audience factor" method of apportionment, which taxpayer concedes the Department has the power to create. IC § 6-8.1-3-3(a). However, taxpayer contends that the Department has not followed the provisions of Title 4, Chapter 2 of the Indiana Code governing the procedure with which the Department can make an "addition, amendment, or repeal of a rule in every rulemaking action." IC § 4-22-2-13(a). This, taxpayer concludes, is a violation of Indiana's version of the Administrative Procedure Act, and in effect makes the Department's use of the "audience factor" invalid. In further support, taxpayer cites Metromedia, Inc. v. New Jersey Division of Taxation as a relevant case where the New Jersey Supreme Court held that the New Jersey Division of Taxation did not have the authority to apply the "audience factor." Metromedia, Inc. v. New Jersey Division of Taxation, 97 N.J. 313 (1984).

It is the Department's position that Metromedia or the other cases cited by the taxpayer are inapplicable. Indiana courts have not made a decision concerning whether the use of an "audience factor" by the Department is indeed a rulemaking action. While New Jersey and Maryland may have decided differently, it has no bearing on Indiana or the Department.

The Department believes that the use of an "audience factor" for apportionment purposes is not a "rulemaking action." It is instead an "agency action," which is not considered to be a rulemaking action. IC § 4-22-2-3(c). An "agency action" is defined as "[t]he whole or a part of an order." IC § 4-21.5-1-4(1). An "order" is then defined as "an agency action of particular applicability that determines the legal rights, duties, privileges, immunities, *or other legal interests of one (1) or more specific persons*." IC § 4-21.5-1-9 (*Emphasis added).* "Corporations" fall under the definition of "persons." IC § 4-22-2-3(e). Under this construction, the Department was well within its rights to decide what it did and made a completely valid action in applying the "audience factor."

The Department, as well as any taxpayer, has the authority by the Indiana Code to use a method of allocation and apportionment that effectuates a result that more fairly represents the income derived from within the state. IC § 6-3-2-2(l). This has been established by numerous cases. By arguing that the Department does not have the right to use a certain method of apportionment, the taxpayer by its very argument has ipso facto argued that taxpayer is also without power to use another form of apportionment, which is clearly wrong.

The second argument taxpayer puts forth stems from the audit's application of 45 IAC 3.1-1-62, which states that:

> All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) *[45 IAC 3.1-1-37.45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources*. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects *does not fairly attribute income to this state or other states*. *It is anticipated that these situations will arise only in limited and unusual circumstances* (which ordinarily will be unique and nonrecurring) *when the standard apportionment provisions produce incongruous results*. (*Emphasis added*).

Taxpayer believes that this regulation should only be used in limited or unusual situations. However, that is precisely the point. The "audience factor" method of apportionment is being applied to a limited and unusual situation in the matter before the Department. The Department has the authority to apply this statute to effectuate a result that more fairly represents taxpayer's income derived from sources within the state.

IC § 6-3-2-2(a) provides as follows:

> With regard to corporations and nonresident persons "adjusted gross income derived from sources with Indiana," for purposes of this article, shall mean and include:
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> (1) income from real or tangible personal property located in this state;

> (2) income from doing business in this state;
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> (3) income from a trade or profession conducted in this state;
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> (4) compensation from a trade or profession conducted in this state; and
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> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

The Department's regulation sets out a definition for "doing business" within the state. 45 IAC 3.1-1-38 states:

> For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such a state including, but not limited to:
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> (1) Maintenance of an office or other place of business in the state
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> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
>
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
>
> (4) *Rendering services to customers in the state*
>
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
>
> (6) Acceptance of orders in the state
>
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income. 45 IAC 3.1-1-38 (*Emphasis added*).

The plain language of the law states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect *to all or any part of the taxpayer's business activity* . . . the employment of *any other method* to effectuate an equitable allocation and apportionment of the taxpayer's income." IC 6-3-2-2(l) (*Emphasis added*). The "audience factor" is an appropriate method to effectuate an outcome that more equitably reflects the taxpayer's income from Indiana sources.

Pursuant to IC § 6-8.1-5-1(b), taxpayer has failed to meet its burden of rebutting the presumption that the original audit decision was correct. Taxpayer does not make a compelling argument as to why the "audience factor" method of apportionment does not fairly reflect the taxpayer's corporate income from Indiana sources and why the "cost of performance" method would more fairly reflect the taxpayer's income.

Finding

Taxpayer's protest is respectfully denied.

III. Tax Administration – Ten Percent Negligence Penalty

Discussion

The taxpayer protests the imposition of the ten percent (10 percent) negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
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> (2) judicial precedents set by Indiana courts;
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> (3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

Finding

The taxpayer's protest to the imposition of penalty is sustained.

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